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DRAFT AMENDMENTS RELATING TO THE RESOURCE ALLOWANCE AND OTHER MATTERS

Finance Minister Paul Martin today released draft legislation and revised draft regulations dealing with the resource allowance and related matters.

The draft amendments include new measures designed to provide for a more stable interim resource allowance structure until further changes come into effect after 1996, as outlined in the Budget. There are also new rules providing for depreciable property treatment in connection with certain assets built by taxpayers. New rules also clarify the treatment of refund interest for corporations that engage in resource activities and the determination of Canadian exploration expenses, Canadian development expenses and foreign exploration and development expenses.

Most of the draft amendments relate directly to the resource allowance, which is provided to taxpayers instead of allowing for the deduction of provincial Crown royalties and mining taxes in computing income. These amendments clarify original draft regulations issued in July 1992 and further draft regulations, issued in March 1993, dealing with the calculation of the resource allowance for members of partnerships.

The 1992 draft regulations were issued in response to a court case (*The Queen v. Gulf Canada Limited*) which has resulted in substantial tax refunds, together with interest, becoming payable in the mining and oil and gas sectors. The Government took steps to reduce its

future risks with respect to the adverse interpretation of the law by passing legislation in June 1995 which requires all large corporations to specify and quantify their outstanding tax issues.

The draft regulations will be processed as soon as possible. The draft amendments to the Act will be included as part of the package of income tax amendments needed to implement the proposals in the Budget.

The draft amendments, together with an overview and detailed explanatory notes, are attached. References in the notes and draft amendments to "Budget Day" and "Budget Day - 1" should be read as references to today's date and yesterday's date, respectively.

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OVERVIEW

The draft amendments released today cover a number of issues, but primarily affect taxpayers in the mining and oil and gas sectors. The issues of most interest to taxpayers outside these sectors are the draft amendments affecting the tax treatment of certain roads and other properties funded, but not owned, by taxpayers. An overview of the proposed amendments is provided below. These amendments are described in detail in the accompanying explanatory notes.

1. Terminology: "Gross Resource Profits", "Resource Profits" and "Adjusted Resource Profits"

Under the existing *Income Tax Regulations*, "resource profits" are determined under subsection 1204(1) of the Regulations. 25 per cent of "resource profits" (after a number of adjustments) may be deducted under paragraph 20(1)(*v*.1) of the Act in computing income. The deduction is known as the "resource allowance". The determination of resource profits is also relevant in computing the special depletion deductions available to taxpayers under section 65 of the Act.

Under the amendments, "resource profits" will be determined under subsection 1204(1.1) of the Regulations, rather than subsection 1204(1). Instead, the amount determined under subsection 1204(1) will be referred to as "gross resource profits" in recognition of the fact that the Courts determined in the Gulf case that the existing regulations were not sufficiently broad to require the allocation of certain deductions (specifically, certain capital cost allowance claims and scientific research expenditures). The resource allowance will be determined with reference to 25 per cent of "adjusted resource profits", which is defined in subsection 1210(2) of the Regulations.

2. Allocation of Deductions to "Resource Profits" and "Adjusted Resource Profits"

Every amount that is deducted in computing a taxpayer's income for a taxation year will also be required to be deducted in computing the taxpayer's "resource profits" and "adjusted resource profits" for the year unless there is an exemption provided.

The exemptions are designed to preserve the existing treatment of a number of specified deductions (including depletion deductions, exploration and development expenditures, deductions in respect of resource properties and interest deductions) and to allow for the reasonable allocation of deductions to profit-earning activities that fall outside the scope of activities covered by the "resource profits" and "adjusted resource profits" definitions.

The revised amendments in this regard clarify the draft amendments released in July 1992 in response to the Gulf case and apply to taxation years that end after July 23, 1992.

3. Resource Allowance and Partnerships

The Act no longer allows the resource allowance to be used to increase the loss or reduce the income that is allocated by a partnership to its members. Instead, a partnership's adjusted resource profits or losses will be allocated under the draft amendments to partners for the purpose of determining each partner's own resource allowance. These rules are designed to prevent partnerships from being used to maximize the resource allowance through the isolation of profit-earning and loss-producing resource properties.

The current draft amendments clarify those released in March 1993 to deal with the resource allowance and partnerships.

4. Treatment of Net Profit Interests

Under the existing resource allowance rules, royalty payments made by a taxpayer with a working interest in a resource property to a taxpayer who holds a net profit interest in that property do not result in any reduction of the payer's resource allowance. Conversely, royalties received on net profits interests are not allowed to increase resource allowance.

This treatment has given rise to a number of financing arrangements under which net profit interests are used to significantly increase the overall resource allowance that is available. By carving out a net profit interest from a working interest, the holder of the working

interest can substantially decrease the amount paid for depreciable properties associated with the working interest. As a consequence, the amount of the resource profits that qualify for the resource allowance can be inappropriately increased.

To address this issue in a manner which minimizes complexity, it is proposed to make a further adjustment in the way in which adjusted resource profits are computed. A royalty on a net profit interest – referred to in the law as a "specified net royalty" – paid by the holder of a working interest will now be required to be deducted in computing the payer's adjusted resource profits. However, the recipient will be allowed to include 1/2 of the royalty in computing the recipient's adjusted resource profits. This adjustment is to apply to royalties paid on net profit interests created after [Budget Day – 1].

5. Treatment of Service Income

The draft amendments clarify that, in general, income from services rendered is not treated as resource profits for the purposes of the resource allowance and the capital cost allowance rules. This recognizes that the providers of services are not required to bear the cost of Crown royalties or mining taxes. These amendments are contained in draft paragraphs 1102(1)(*a*) and 1204(3)(*c*) of the Regulations.

6. Anti-Avoidance

The draft amendments contain an anti-avoidance rule that is designed to prevent taxpayers from entering into arrangements with non-arm's length parties in order to minimize the costs that are allocated to resource profits and adjusted resource profits. In these circumstances, the draft amendments generally require the reduction of a taxpayer's resource profits and adjusted resource profits to the extent that the amount charged is less than the fair market value of any property or services provided to the taxpayer. For further details, see amended paragraph 1204(1.1)(*c*) and new subsection 1204(1.2) of the Regulations.

7. Refund Interest

The draft amendments ensure that corporations in the mining and oil and gas sectors will not be entitled to increase their entitlement to the manufacturing and processing tax credit because of the receipt of refund interest. These amendments should not be construed as implying that the receipt of refund interest previously had the result of increasing such entitlement. Refund interest is defined in draft subsection 5203(4) of the Regulations as interest arising from the overpayment of income and mining taxes, Crown royalties and similar amounts.

8. Canadian Exploration Expense, Canadian Development Expense and Foreign Exploration and Development Expenses

The definitions of these expressions in sections 66 to 66.2 of the Act will be amended to clarify that they do not reflect the capital cost of depreciable property. These definitions are relevant for the purpose of the resource allowance rules because such resource expenditures generally do not result in a reduction of adjusted resource profits.

9. Special Rules for Roads and Other Properties not Owned by a Taxpayer

In a number of cases, taxpayers may incur costs or make expenditures relating to the building or use of roads or similar properties where the taxpayer does not actually acquire ownership of the property. New subsection 13(7.5) of the Act generally will provide for depreciable property treatment in these circumstances. This amendment is linked to the changes to the resource allowance rules because capital cost allowance deducted in respect of depreciable property is required to reduce resource profits and adjusted resource profits.

DRAFT AMENDMENTS RELATING TO THE RESOURCE ALLOWANCE AND OTHER MATTERS

(a) *Income Tax Act*

1.(1) Section 13 of the *Income Tax Act* is amended by adding the following after subsection (7.4):

Deemed capital cost

(7.5) For the purposes of this Act,

(*a*) where a taxpayer is required under the terms of a contract made after [Budget Day - 1] to make a payment to Her Majesty in right of Canada or a province or to a Canadian municipality in respect of costs incurred or to be incurred by the recipient to acquire a property prescribed in respect of the taxpayer,

(i) the taxpayer is deemed to have acquired the property at a capital cost equal to the portion of that payment made by the taxpayer that can reasonably be regarded as being in respect of those costs, and

(ii) the time of acquisition of the property by the taxpayer is deemed to be the later of the time the payment is made and the time at which those costs are incurred;

(*b*) where

(i) at any time after [Budget Day - 1] a taxpayer incurs a cost on account of capital for the building of, for the right to use or in respect of, a prescribed property, and

(ii) the amount of the cost would, if this paragraph did not apply, not be included in the capital cost to the taxpayer of depreciable property of a prescribed class,

the taxpayer is deemed to have acquired the property at that time at a capital cost equal to the amount of the cost;

(*c*) where a taxpayer acquires an intangible property as a consequence of making a payment to which paragraph (*a*) applies or incurring a cost to which paragraph (*b*) applies,

(i) the property referred to in paragraph (*a*) or (*b*) is deemed to include the intangible property, and

(ii) the portion of the capital cost referred to in paragraph (*a*) or (*b*) that applies to the intangible property is deemed to be the amount determined by the formula

A X B/C

where

A is the lesser of the amount of the payment or cost and the amount determined for C,

B is the fair market value of the intangible property at the time the payment was made or the cost was incurred, and

C is the fair market value at the time the payment was made or the cost was incurred of all intangible properties acquired as a consequence of making the payment or incurring the cost; and

(*d*) any property deemed by paragraph (*a*) or (*b*) to have been acquired at any time by a taxpayer as a consequence of making a payment or incurring a cost

(i) is deemed to have been acquired for the purpose for which the payment was made or the cost was incurred, and

(ii) is deemed to be owned by the taxpayer at any subsequent time that the taxpayer benefits from the property.

(2) Subsection (1) applies to taxation years that end after [Budget Day - 1].

2.(1) The definition "foreign exploration and development expenses" in subsection 66(15) of the Act is amended by adding the following after paragraph (*e*):

but, for greater certainty, does not include any amount included in the capital cost to the taxpayer of any depreciable property of a prescribed class acquired by the taxpayer;

(2) Subsection (1) applies to property acquired after [Budget Day - 1].

3.(1) The definition "Canadian exploration expense" in subsection 66.1(6) of the Act is amended by striking out the word "or" at the end of paragraph (*j*) and by adding the following after paragraph (*k*):

(*l*) any amount included in the capital cost to the taxpayer of any depreciable property of a prescribed class acquired by the taxpayer, or

(*m*) the taxpayer's share of any consideration, expense or cost referred to in any of paragraphs (*j*) to (*l*) incurred by a partnership,

(2) Subsection (1) applies to property acquired after [Budget Day - 1].

4.(1) The definition "Canadian development expense" in subsection 66.2(5) of the Act is amended by striking out the word "or" at the end of paragraph (*h*) and by adding the following after paragraph (*i*):

(*j*) any amount included in the capital cost to the taxpayer of any depreciable property of a prescribed class, or

(*k*) the taxpayer's share of any consideration, expense or cost referred to in any of paragraphs (*h*) to (*j*) incurred by a partnership,

(2) Subsection (1) applies to property acquired after [Budget Day - 1].

(b) *Income Tax Regulations*

1.(1) Paragraph 1102(1)(*a*) of the *Income Tax Regulations* is replaced by the following:

(*a*) the cost of which would be deductible in computing the taxpayer's income if the Act were read without reference to sections 66 to 66.4 of the Act;

(2) Section 1102 of the Regulations is amended by adding the following after subsection (14.1):

Townsite Costs

(14.2) For the purpose of paragraph 13(7.5)(*a*) of the Act, a property is prescribed in respect of a taxpayer where the property would, if it had been acquired by the taxpayer, be property included in Class 10 in Schedule II because of paragraph (*l*) of that Class.

Surface Construction and Bridges

(14.3) For the purpose of paragraph 13(7.5)(*b*) of the Act, prescribed property is any of

(*a*) a road (other than a temporary access road to an oil or gas well in Canada), sidewalk, airplane runway, parking area, storage area or similar surface construction,

(*b*) a bridge, and

(*c*) a property that is ancillary to any of the properties described in paragraph (*a*) or (*b*).

(3) Subsection 1102(18) of the Regulations and the heading before it are repealed.

2. Section 1104 of the Regulations is amended by adding the following after subsection (6):

(6.1) Notwithstanding subsections (5) and (6),

(*a*) for the purposes of paragraphs 1100(1)(*w*) to (*ya*), subsections 1101(4*a*) to (4*d*) and Class 28 in Schedule II, "income from a mine", or any expression referring to a taxpayer's income from a mine, does not include income that can reasonably be attributed to a service rendered by the taxpayer; and

(*b*) for the purpose of Class 10 in Schedule II, "income from a mine" does not include income that can reasonably be attributed to a service rendered by the taxpayer other than the processing of ore.

3.(1) The portion of subsection 1204(1) of the Regulations before paragraph (*a*) is replaced by the following:

1204.(1) For the purposes of this Part, "gross resource profits" of a taxpayer for a taxation year means the amount, if any, by which the total of

(2) Clause 1204(1)(*b*)(i)(B) of the Regulations is replaced by the following:

(B) natural accumulations (other than mineral resources) of petroleum or natural gas in Canada operated by the taxpayer,

(3) Paragraph 1204(1)(*b*.1) of the Regulations is replaced by the following:

(*b*.1) the total of all amounts (other than an amount included because of paragraph (*b*) in computing the taxpayer's gross resource profits for the year) each of which is an amount included in computing the taxpayer's income for the year as a rental or royalty computed by reference to the amount or value of production from a natural accumulation of petroleum or natural gas in Canada, an oil or gas well in Canada or a mineral resource in Canada, and

(4) Paragraph 1204(1)(*f*) of the Regulations is replaced by the following:

(*f*) any other deductions for the year that can reasonably be regarded as applicable to the sources of income described in paragraph (*b*) or (*b*.1), other than a deduction under paragraph 20(1)(*ss*) or (*tt*) of the Act or section 1201 or subsection 1202(2), 1203(1), 1207(1) or 1212(1).

(5) Section 1204 of the Regulations is amended by adding the following after subsection 1204(1):

(1.1) For the purposes of this Part, "resource profits" of a taxpayer for a taxation year means the amount, if any, by which

(*a*) the taxpayer's gross resource profits for the year

exceeds the total of

(*b*) all amounts deducted in computing the taxpayer's income for the year other than

(i) an amount deducted in computing the taxpayer's gross resource profits for the year,

(ii) an amount deducted under any of section 8, paragraphs 20(1)(*ss*) and (*tt*), sections 60 to 64 and subsections 66(4), 66.7(2) and 104(6) and (12) of the Act and section 1201 and subsections 1202(2), 1203(1), 1207(1) and 1212(1) in computing the taxpayer's income for the year,

(iii) an amount deducted under section 66.2 of the Act in computing the taxpayer's income for the year, to the extent that it is attributable to any right, licence or privilege to store underground petroleum, natural gas or related hydrocarbons in Canada,

(iv) an amount deducted in computing the taxpayer's income for the year from a business, or other source, that does not include any resource activity of the taxpayer, and

(v) an amount deducted in computing the taxpayer's income for the year, to the extent that the amount

(A) relates to an activity

(I) that is not a resource activity of the taxpayer, and

(II) that is

1. the production, processing, manufacturing, distribution, marketing, transportation or sale of any property,

2. carried out for the purpose of earning income from property, or

3. the rendering of a service by the taxpayer to another person for the purpose of earning income of the taxpayer, and

(B) does not relate to a resource activity of the taxpayer,

(*c*) all amounts each of which is an amount, if any, by which

(i) the amount that would have been charged to the taxpayer by a person or partnership with whom the taxpayer was not dealing at arm's length if the taxpayer and that person or partnership had been dealing at arm's length

(A) for the use after [Budget Day - 1] and in the year of a property (other than money) owned by that person or partnership, or

(B) for the provision after [Budget Day - 1] and in the year by that person or partnership of a service to the taxpayer

exceeds the total of

(ii) the amount charged to the taxpayer for the use of that property or the provision of that service in that period, and

(iii) the portion of the amount described in subparagraph (i) that, if it had been charged, would not have been deductible in computing the taxpayer's resource profits, and

(*d*) where the year ends after February 21, 1994, all amounts added under subsection 80(13) of the Act in computing the taxpayer's gross resource profits for the year.

(1.2) For the purposes of paragraph (1.1)(*c*) and this subsection,

(*a*) a taxpayer is considered not to deal at arm's length with a partnership where the taxpayer does not deal at arm's length with any member of the partnership;

(*b*) a partnership is considered not to deal at arm's length with another partnership where any member of the first partnership does not deal at arm's length with any member of the second partnership;

(*c*) where a taxpayer is a member, or is deemed by this paragraph to be a member, of a partnership that is member of another partnership, the taxpayer is deemed to be a member of the other partnership; and

(*d*) the provision of a service to a taxpayer does not include the provision of a service by an individual in the individual's capacity as an employee of the taxpayer.

(6) Subsection 1204(3) of the Regulations is replaced by the following:

(3) A taxpayer's income or loss from a source described in paragraph (1)(*b*) does not include

(*a*) any income or loss derived from transporting, transmitting or processing (other than processing described in clause (1)(*b*)(ii)(C), (iii)(C) or (iv)(C) or subparagraph (1)(*b*)(v)) petroleum, natural gas or related hydrocarbons;

(*b*) any income or loss arising because of the application of any of paragraphs 12(1)(*z*.1) or (*z*.2) or section 107.3 of the Act; and

(*c*) any income or loss that can reasonably be attributed to a service rendered by the taxpayer other than processing described in subparagraph (1)(*b*)(iii), (iv) or (v).

(7) Subsection 1204(6) of the Regulations is repealed.

4.(1) The portion of paragraph 1205(1)(*b*) of the Regulations before subparagraph (i) is replaced by the following:

(*b*) all amounts, in respect of expenditures (other than expenditures referred to in paragraph (*a*) or expenditures to acquire property under circumstances that entitled the taxpayer to a deduction under section 1202 or would so entitle the taxpayer if the amounts referred to in paragraphs 1202(2)(*a*) and (*b*) were sufficient for the purpose) incurred by the taxpayer after May 8, 1972 and before the particular time, each of which was the stated percentage of the capital cost to the taxpayer of property that is or, but for Class 41 would be, included in Class 10 in Schedule II because of paragraph (*k*) of the description of that Class and that was acquired for the purpose of processing in Canada

(2) Paragraph 1205(1)(*d*.1) of the Regulations is replaced by the following:

(*d*.1) three times the total of all amounts each of which is an amount equal to the lesser of

(i) the amount that would be determined under subsection 1210(1) in computing the taxpayer's income for a taxation year that ends before the particular time, if the amount determined for C under that subsection were nil, and

(ii) the amount determined for C under subsection 1210(1) in respect of the taxpayer for that year, and

5.(1) Subsection 1206(1) of the Regulations is amended by adding the following definitions in alphabetical order:

"exempt partnership" in respect of a taxpayer at a particular time means a partnership of which the taxpayer was a member throughout the period beginning on December 20, 1991 and ending at the particular time, where all or substantially all of the fair market value of the property of the partnership at the particular time is attributable to property held in connection with one or more working interests that were held by the partnership on December 20, 1991 for the production of minerals, petroleum, natural gas or related hydrocarbons, unless

(*a*) any of the depreciable property acquired after December 20, 1991 and before the particular time by the partnership in connection with one of the working interests had, before the time of the acquisition, been owned by the taxpayer (or any other person with whom the taxpayer did not deal at arm's length) and been used by the taxpayer (or that other person) in connection with that working interest, or

(*b*) it is reasonable to consider that, before the particular time, amounts were charged to the partnership that would not have been so charged if section 1210 were read without reference to subsection (4) of that section; (*société de personnes exclue*)

"resource activity" of a taxpayer means

(*a*) the production by the taxpayer of petroleum, natural gas or related hydrocarbons from

(i) an oil or gas well in Canada, or

(ii) a natural accumulation (other than a mineral resource) of petroleum or natural gas in Canada,

(*b*) the production and processing in Canada by the taxpayer or the processing in Canada by the taxpayer of

(i) ore (other than iron ore or tar sands ore) from a mineral resource in Canada to any stage that is not beyond the prime metal stage or its equivalent,

(ii) iron ore from a mineral resource in Canada to any stage that is not beyond the pellet stage or its equivalent, and

(iii) tar sands ore from a mineral resource in Canada to any stage that is not beyond the crude oil stage or its equivalent,

(*c*) the processing in Canada by the taxpayer of heavy crude oil recovered from an oil or gas well in Canada to any stage that is not beyond the crude oil stage or its equivalent,

(*d*) the processing in Canada by the taxpayer of

(i) ore (other than iron ore or tar sands ore) from a mineral resource outside Canada to any stage that is not beyond the prime metal stage or its equivalent,

(ii) iron ore from a mineral resource outside Canada to any stage that is not beyond the pellet stage or its equivalent, and

(iii) tar sands ore from a mineral resource outside Canada to any stage that is not beyond the crude oil stage or its equivalent, or

(*e*) the ownership by the taxpayer of a right to a rental or royalty computed by reference to the amount or value of production from a natural accumulation of petroleum or natural gas in Canada, an oil or gas well in Canada or a mineral resource in Canada,

and, for the purposes of this definition,

(*f*) the production of a substance by a taxpayer includes exploration and development activities of the taxpayer with respect to the substance, whether or not extraction of the substance has begun or will ever begin,

(*g*) the production, the processing or the production and processing of a substance by a taxpayer includes activities performed by the taxpayer that are ancillary to, or in support of, the production, the processing or the production and processing of that substance by the taxpayer,

(*h*) the production or processing of a substance by a taxpayer includes an activity (including the ownership of property) that is undertaken before the extraction of the substance and that is undertaken for the purpose of extracting or processing the substance,

(*i*) the production, the production and processing or the processing of a substance by a taxpayer includes activities that the taxpayer is obliged to undertake as a direct consequence of the production, production and processing or processing of that substance by the taxpayer, whether or not the production, the production and processing or the processing of the substance by the taxpayer has ceased, and

(*j*) notwithstanding paragraphs (*a*) to (*i*), the production, the production and processing or the processing of a substance does not include any activity of a taxpayer that is part of a source described in paragraph 1204(1)(*b*), where

(i) the activity

(A) is the transporting, transmitting or processing (other than processing described in subparagraph (*b*)(iii), paragraph (*c*) or subparagraph (*d*)(iii)) of petroleum, natural gas or related hydrocarbons, or

(B) can reasonably be attributed to a service rendered by the taxpayer, and

(ii) revenues derived from the activity are not taken into account in computing the taxpayer's gross resource profits; (*activité extractive*)

"specified net royalty" means a royalty (other than a production royalty) created after [Budget Day - 1] (otherwise than pursuant to an agreement in writing made before Budget Day) where

(*a*) any amount paid or payable to the holder of the royalty because of the holder's interest in the royalty is calculated with reference to any expense, or

(*b*) an arrangement involving the reimbursement of, contribution to or allowance for, any expense has been made after [Budget Day - 1] and it is reasonable to consider that one of the reasons for the arrangement is to avoid the application of paragraph (*a*) in respect of the royalty; (*redevance nette déterminée*)

(2) Paragraphs (*a*) and (*b*) of the definition "processing property" in subsection 1206(1) of the Regulations are replaced by the following:

(*a*) that is included in Class 10 of Schedule II because of paragraph (*g*) of the description of that Class or would be so included if that paragraph were read without reference to subparagraph (ii) of that paragraph and Schedule II were read without reference to Class 41, or

(*b*) that is included in Class 10 in Schedule II because of paragraph (*k*) of the description of that Class or would be so included if that paragraph were read without reference to the words following subparagraph (ii) of that paragraph and Schedule II were read without reference to Class 41,

(3) Subparagraph (*a*)(ii) of the definition "production royalty" in subsection 1206(1) of the Regulations is replaced by the following:

(ii) the ownership of property to which such production relates where the Crown royalty is computed by reference to an amount of production from the accumulation, oil or gas well or resource,

(4) The portion of subsection 1206(9) of the Regulations after paragraph (*d*) is replaced by the following:

less, in respect of an amount described in paragraph (*a*) or (*b*), the amount of any reimbursement, contribution or allowance referred to in section 80.2 of the Act received or receivable by the taxpayer in respect of that amount.

6.(1) The heading before subsection 1210(1) of the Regulations is replaced by the following:

Resource Allowance

(2) Section 1210 of the Regulations is replaced by the following:

1210.(1) For the purpose of paragraph 20(1)(*v*.1) of the Act, there may be deducted in computing the income of a taxpayer for a taxation year the amount determined by the formula

.25(A - B) - C

where

A is the taxpayer's adjusted resource profits for the year;

B is the total of all amounts each of which is a Canadian exploration and development overhead expense made or incurred by the taxpayer in the year, other than an amount included therein because of subsection 21(2) or (4) of the Act; and

C is the amount, if any, by which

(*a*) the total of all amounts determined under paragraphs 1205(1)(*e*) to (*k*) in computing the taxpayer's earned depletion base at the end of the year, other than any portion of that total determined under paragraph 1205(1)(*i*) as a consequence of a disposition in the year of property in circumstances to which subsection 1202(2) applies

exceeds

(*b*) 33 1/3 per cent of the total of all amounts determined under paragraphs 1205(1)(*a*) to (*d*.2) in computing the taxpayer's earned depletion base at the end of the year.

(2) For the purposes of this section, "adjusted resource profits" of a taxpayer for a taxation year is the amount, which may be positive or negative, determined by the formula

A + B - C

where

A is the amount that would be the taxpayer's resource profits for the year if the following assumptions were made:

(*a*) the amount determined under paragraph 1204(1)(*a*) were nil,

(*b*) subsection 1204(1) were read without reference to subparagraph 1204(1)(*b*)(iv) and the definition "resource activity" in subsection 1206(1) were read without reference to paragraph (*d*) of that definition,

(*c*) the following amounts were not deducted in computing the taxpayer's gross resource profits for the year and were not deducted in computing the taxpayer's resource profits for the year:

(i) each amount deducted in computing the taxpayer's income for the year in respect of a rental or royalty paid or payable by the taxpayer (other than an amount prescribed in section 1211, an amount that is a production royalty or an amount paid or payable in respect of a specified net royalty) computed by reference to the amount or value of petroleum, natural gas or related hydrocarbons

(A) produced from a natural accumulation (other than a resource) of petroleum or natural gas in Canada or an oil or gas well in Canada, or

(B) produced from a resource that is a bituminous sands deposit, oil sands deposit or oil shale deposit,

(ii) each amount deducted in computing the taxpayer's income for the year

(A) under any of paragraphs 20(1)(*e*), (*e*.1), (*e*.2) and (*f*) of the Act, or

(B) as, on account of or in lieu of, interest in respect of a debt owed by the taxpayer, and

(iii) each amount deducted under any of paragraph 20(1)(*v*.1) and sections 65 to 66.7 of the Act and subsections 17(2) and (6) and section 29 of the *Income Tax Application Rules*,

(*d*) each amount that is the taxpayer's share of the income or loss of a partnership from any source were not taken into account, and

(*e*) subsections 1204(1) and (1.1) provided for the computation of negative amounts where the amounts subtracted in computing gross resource profits and resource profits exceed the amounts added in computing those amounts;

B is the total of all amounts each of which is the taxpayer's share of the adjusted resource profits of a partnership for the year, as determined under subsection (3) or (4), and

C is the amount, if any, by which the total of

(*a*) the total of all amounts each of which is an amount included in the taxpayer's gross resource profits for the year as a rental or royalty (other than a production royalty or a specified net royalty) computed by reference to the amount or value of petroleum, natural gas or related hydrocarbons produced from

(i) a natural accumulation (other than a resource) of petroleum or natural gas in Canada or an oil or gas well in Canada, or

(ii) a resource that is a bituminous sands deposit, oil sands deposit or oil shale deposit, and

(*b*) 1/2 of all amounts included in computing the taxpayer's gross resource profits for the year in respect of specified net royalties

exceeds

(*c*) where the year ends after [Budget Day - 1], the total of all outlays and expenses that were made or incurred in respect of the total described in paragraph (*a*) to the extent that the outlays and expenses were deducted in computing the taxpayer's gross resource profits for the year.

(3) Where a taxpayer is a member of a partnership in a fiscal period of the partnership that ends in a taxation year of the taxpayer, the taxpayer's share of the partnership's adjusted resource profits for the year is

(*a*) nil, where the fiscal period began before December 21, 1991, and

(*b*) in any other case, the amount, which may be positive or negative, that could, if this subsection did not apply, reasonably be considered to represent the taxpayer's share of the partnership's adjusted resource profits for the fiscal period, determined on the assumption that each partnership is a taxpayer the fiscal period of which is a taxation year.

(4) Notwithstanding subsection (3), where a taxpayer is a member of an exempt partnership in a fiscal period of the partnership that begins before 2000 and ends in a taxation year of the taxpayer and the taxpayer's share of the partnership's adjusted resource profits for the year would, if this subsection did not apply, be a negative amount, the taxpayer's share of the partnership's adjusted resource profits for the year is the amount, which may be positive or negative, determined by the formula

A X B

where

A is the amount that would, if this subsection did not apply, be the taxpayer's share of the partnership's adjusted resource profits for the year, and

B is

(*a*) nil, where

(i) the partnership is an exempt partnership in respect of the taxpayer at the end of the fiscal period, and

(ii) at the end of the fiscal period, all or substantially all of the assets of the partnership were held in connection with one or more working interests

(A) the production from which began in reasonable commercial quantities before December 21, 1991, or

(B) the production from which was to begin in reasonable commercial quantities after December 20, 1991 in accordance with an agreement in writing made before December 21, 1991, and

(*b*) in any other case, the lesser of one and the amount determined by the formula

C/D

where

C is the amount that would be the partnership's adjusted resource profits for the fiscal period if the partnership did not have any working interest described in subparagraph (*a*)(ii) of the description of B, and

D is the partnership's adjusted resource profits for the fiscal period.

7.(1) The definition "Canadian resource profits" in section 5202 of the Regulations is replaced by the following:

"Canadian resource profits" has the meaning that would be assigned to the expression "resource profits" by section 1204 if

(*a*) section 1204 were read without reference to subparagraph 1204(1)(*b*)(iv), and

(*b*) the definition "resource activity" in subsection 1206(1) were read without reference to paragraph (*d*) of that definition;

(2) The definition "resource profits" in section 5202 of the Regulations is replaced by the following:

"resource profits" has the meaning assigned by section 1204;

8.(1) The portion of the definition "adjusted business income" in subsection 5203(1) of the Regulations after paragraph (*a*) is replaced by the following:

exceeds the total of

(*b*) the net resource income of the corporation for the year, and

(*c*) all amounts each of which is an amount in respect of refund interest included in computing the taxpayer's income for the year, to the extent that the amount is included in the amount otherwise determined under section 5202 to be the adjusted business income of the corporation for the year;

(2) Section 5203 of the Regulations is amended by adding the following after subsection (3):

(4) For the purpose of subsection (1), "refund interest" means an amount that is received, or that becomes receivable, after [Budget Day - 1]

(*a*) from an authority (including a government or municipality) situated in Canada as a consequence of the overpayment of a tax that was not deductible under the Act in computing any taxpayer's income and that was imposed by an Act of Canada or a province or a bylaw of a municipality;

(*b*) from a person described in subparagraph 18(1)(*m*)(i), (ii) or (iii) of the Act as a consequence of the overpayment of an amount that, because of paragraph 18(1)(*m*) of the Act, was not deductible under the Act in computing any taxpayer's income; or

(*c*) from a person described in subparagraph 18(1)(*m*)(i), (ii) or (iii) of the Act as a consequence of the receipt of an amount that was in excess of the amount to which the person was entitled and in respect of an amount that was required to be included in computing any taxpayer's income because of paragraph 12(1)(*o*) of the Act.

9.(1) Subparagraph (*i*)(iv) of Class 8 of Schedule II to the Regulations is replaced by the following:

(iv) an oil or gas well,

(2) Subparagraph (*i*)(vi) of Class 8 of Schedule II to the Regulations is replaced by the following:

(vi) a temporary access road that is to an oil or gas well in Canada and that was built by the taxpayer,

10. Paragraph (*c*) of Class 17 of Schedule II to the Regulations is replaced by the following:

(*c*) a road (other than a temporary access road that is to an oil or gas well in Canada and that was built by the taxpayer), sidewalk, airplane runway, parking area, storage area or similar surface construction.

11.(1) Subsection 1(1) applies to taxation years that end after [Budget Day - 1].

(2) Subsection 1(2) applies after [Budget Day - 1].

(3) Subsection 1(3) applies to payments required to be made under the terms of contracts made after [Budget Day - 1].

(4) Section 2 applies to taxation years that begin after [Budget Day - 1].

(5) Subsections 3(1), subsection 1204(1.1) of the Regulations, as enacted by subsection 3(5), subsection 4(2), the definition "resource activity" in subsection 1206(1) of the Regulations, as enacted by subsection 5(1), subsection 6(1), subsections 1210(3) and (4) of the Regulations, as enacted by subsection 6(2), and section 7 apply to taxation years that begin after December 20, 1991 except that, for each taxation year that began before July 23, 1992, the amount determined under paragraph 1204(1.1)(*b*) of the Regulations, as enacted by subsection 3(5), is deemed to be equal to the amount determined by the formula

A X B/C

where

A is the total that would otherwise be determined under that paragraph,

B is the number of days in the year that are after July 23, 1992, and

C is the number of days in the year.

(6) Subsection 3(2) applies to taxation years that end after March 1985.

(7) Subsections 3(3) and (7) apply to taxation years that begin after 1990.

(8) Subsection 3(4) applies to taxation years that end after February 22, 1994.

(9) Subsection 1204(1.2) of the Regulations, as enacted by subsection 3(5), applies to taxation years that end after [Budget Day - 1].

(10) Subsection 3(6) applies to taxation years that end after February 22, 1994, except that paragraph 1204(3)(*c*) of the Regulations, as enacted by subsection 3(6), does not apply to taxation years that began before Budget Day.

(11) Subsections 4(1) and 5(2) apply to the 1988 and subsequent taxation years.

(12) The definition "exempt partnership" in subsection 1206(1) of the Regulations, as enacted by subsection 5(1), applies to fiscal periods of partnerships that begin after December 20, 1991.

(13) The definition "specified net royalty" in subsection 1206(1) of the Regulations, as enacted by subsection 5(1), applies after [Budget Day - 1].

(14) Subsection 5(3) applies in respect of rentals and royalties computed by reference to the amount or value of petroleum, natural gas or related hydrocarbons produced after June 30, 1988.

(15) Subsection 5(4) applies after January 1990.

(16) Subsection 1210(1) of the Regulations, as enacted by subsection 6(2), applies to taxation years that begin after December 20, 1991 except that, where the year ended before March 19, 1993, the description of B in that subsection of the Regulations shall be read as follows:

B is the total of all amounts each of which is a Canadian exploration and development overhead expense made or incurred by the taxpayer in the year, other than each amount included therein in respect of financing, deducted in computing the taxpayer's income for the year,

(17) Subsection 1210(2) of the Regulations, as enacted by subsection 6(2), applies to taxation years that begin after December 20, 1991 except that, where the year began before March 19, 1993, subparagraph (*c*)(ii) of the description of A in that subsection of the Regulations shall be read as follows:

(ii) each amount in respect of financing deducted in computing the taxpayer's income for the year,

(18) Section 8 applies to taxation years that end after [Budget Day - 1].

(19) Sections 9 and 10 apply to property acquired after [Budget Day - 1].

EXPLANATORY NOTES TO DRAFT AMENDMENTS RELATING TO THE RESOURCE ALLOWANCE AND OTHER MATTERS

(a) *Income Tax Act*

ITA
13(7.5)

New subsection 13(7.5) of the *Income Tax Act* provides rules allowing certain payments and costs to be treated as the capital cost of depreciable property for the purposes of the Act.

Paragraph 13(7.5)(*a*) applies where a taxpayer is required under the terms of a contract that is made after [Budget Day -1] to make a payment to Her Majesty in right of Canada or a province or to a Canadian municipality in respect of certain townsite costs incurred or to be incurred by the recipient to acquire a prescribed property in respect of the taxpayer. Where this is the case, the taxpayer is deemed to have acquired the property at a capital cost equal to the portion of the payment that can reasonably be regarded as being in respect of those costs. The time of acquisition of the property by the taxpayer is deemed to be the later of the time the payment is made and the time at which those costs are incurred. Paragraph 13(7.5)(*a*) replaces existing subsection 1102(18) of the *Income Tax Regulations*. It is proposed that property relating to townsites be prescribed, for the purpose of paragraph 13(7.5)(*a*), in new subsection 1102(14.2) of the Regulations. For further details, see the commentary on that subsection.

Paragraph 13(7.5)(*b*) applies where, at any time after [Budget Day -1], a taxpayer incurs a cost on account of capital for the building of, for the right to use or in respect of a prescribed property and the amount of the cost would otherwise not be included in the capital cost to the taxpayer of depreciable property of a prescribed class. Where this is the case, the taxpayer is deemed at that time to have acquired the property at a capital cost equal to the amount of the cost. It is proposed that property relating to roads and similar projects be prescribed for this purpose in new

subsection 1102(14.3) of the Regulations. For further details, see the commentary on that subsection.

Where a taxpayer acquires an intangible property as a consequence of making a payment or incurring a cost described above, paragraph 13(7.5)(*c*) provides that the intangible property is treated as part of the depreciable property that is deemed to be acquired. The capital cost of a particular intangible property is equal to a proration factor multiplied by the lesser of the deemed capital cost of the depreciable property and the fair market value of all intangible properties so acquired. The proration factor for a particular intangible property is its fair market value divided by the fair market value of all the intangible properties so acquired. The operation of paragraph 13(7.5)(*c*) is illustrated by the example below.

EXAMPLE

In order to be able to establish a factory at a particular location, a taxpayer builds a road to the factory at a cost of $10 million. The road is owned by the municipality in which the factory is located, but the municipality provides the taxpayer with exclusive access to two parts of the road indefinitely. The fair market values of these access rights are $200,000 and $300,000.

Results:

1. The taxpayer is deemed to acquire a road (Class 17 property) for $10 million.

2. The access rights are considered to be part of the road. The capital costs of these rights are, because of paragraph 13(7.5)(*c*), considered to be $200,000 and $300,000, respectively.

Paragraph 13(7.5)(*d*) provides that any property deemed by the above rules to have been acquired at any time by the taxpayer as a consequence of making a payment or incurring a cost

- is deemed to have been acquired for the purpose for which the payment was made or the cost was incurred, and

- is deemed to be owned by the taxpayer at any subsequent time that the taxpayer benefits from the use of the property.

These amendments should be read in conjunction with related amendments to:

- the definitions "foreign exploration and development expenses", "Canadian exploration expense" and "Canadian development expense" in sections 66 to 66.2,

- paragraph 1102(1)(*a*) and subsections 1102(14.2), (14.3) and (18) of the Regulations, and

- Classes 8 and 17 of Schedule II to the Regulations.

The purpose of these amendments is to prevent costs associated with the building of roads and similar projects from being considered as eligible capital expenditures while, at the same time, ensuring that classification of such costs as Canadian exploration expenses, Canadian development expenses and foreign exploration and development expenses is restricted to the building of temporary access roads to oil and gas wells. The resulting capital cost allowance claimed by a taxpayer in respect of such costs can result in a reduction of the taxpayer's resource allowance under section 1210 of the Regulations.

By way of illustration, the rates of write-off provided for capital expenditures for the building of roads are as follows:

- expenditures for building temporary access roads to oil and gas wells in Canada are generally classified as Canadian exploration expenses (100% rate) or Canadian development expenses (30% rate) – no other roads qualify for this treatment,

- capital expenditures in building certain roads in relation to a mine fall under Class 41 (25% rate, with higher rate in some cases to allow write-off against mine income),

- expenditures in building forestry roads are, unless the taxpayer elects otherwise, generally depreciated under Class 15 at a rate corresponding to the rate of production from the timber limit to which the road relates,

- other expenditures in building forestry roads generally are depreciated under Class 10(n) or (p) (30% rate), and

- other expenditures for roads are depreciated at an 8% rate under Class 17.

These amendments apply to taxation years that end after [Budget Day - 1].

ITA
66(15)

"foreign exploration and development expenses"

Subsection 66(15) of the Act defines the expression "foreign exploration and development expenses" (FEDE). It includes specified exploration expenses incurred in exploring for petroleum or minerals outside Canada.

The definition is amended to clarify that a taxpayer's FEDE does not include a cost to the taxpayer of any depreciable property of a prescribed class acquired after [Budget Day - 1].

This amendment is consistent with parallel changes to the definition "Canadian exploration expense" in subsection 66.1(6) and the definition "Canadian development expense" in subsection 66.2(5). For further discussion, see the commentary below on the amendments to the "Canadian exploration expense" definition.

ITA
66.1(6)

"Canadian exploration expense"

Subsection 66.1(6) of the Act defines the expression "Canadian exploration expense" (CEE).

The definition is amended to clarify that a taxpayer's CEE does not include the cost to the taxpayer of any depreciable property of a prescribed class acquired after [Budget Day - 1]. This amendment, as well as the related amendments to the definitions "Canadian development expense" and "foreign exploration and development expenses", are for greater certainty and should not be construed as implying that the cost of depreciable property was previously considered to qualify under those definitions.

As a consequence of this amendment, it is clear that the determination of whether property is depreciable property is made before the determination of whether the cost of the property qualifies as CEE. In the event that the property is depreciable property, its cost will not be CEE. In this connection, it is noted that new subsection 13(7.5) generally ensures depreciable property treatment for costs associated with the building of roads and similar projects.

A related change to this definition ensures that a taxpayer's share of a cost described above incurred by a partnership is likewise not taken into account for the purpose of determining a taxpayer's CEE.

ITA
66.2(5)

"Canadian development expense"

Subsection 66.2(5) of the Act defines the expression "Canadian development expense" (CDE).

The definition is amended to clarify that a taxpayer's CDE does not include a cost to the taxpayer of any depreciable property of a prescribed class acquired after [Budget Day - 1].

This amendment is consistent with parallel changes to the definition "Canadian exploration expense" in subsection 66.1(6) and the definition "foreign exploration and development expenses" in subsection 66.2(5). For further discussion, see the commentary above on the amendments to the definition "Canadian exploration expense".

(b) *Income Tax Regulations*

ITR
1102(1)(*a*)

Subsection 1102(1) of the Regulations provides that certain properties are excluded as depreciable properties under Schedule II to the Regulations. Under paragraph 1102(1)(*a*), a taxpayer's property is excluded for this purpose if its cost is deductible in computing the taxpayer's income.

Paragraph 1102(1)(*a*) is amended to provide that it does not apply to a property the cost of which is deductible under any of sections 66 to 66.4 of the Act. This amendment is made in order to resolve any circularity between the resource provisions and the depreciable property provisions. In this regard, it is noted that there are a number of references in these sections to depreciable property, including new references in the amended definitions "Canadian exploration expense" and "Canadian development expense" in subsections 66.1(6) and 66.2(5) of the Act. The amendment to paragraph 1102(1)(*a*) ensures that the determination of whether property is depreciable property is generally made before determining whether the cost the property is eligible for deduction under any of sections 66 to 66.4.

These amendments apply to taxation years that end after [Budget Day - 1].

ITR
1102(14.2), (14.3) and (18)

New subsection 1102(14.2) of the Regulations prescribes property for the purpose of the rules relating to depreciable property in paragraph 13(7.5)(*a*) of the Act, which is described in the commentary above. The properties to be prescribed after

[Budget Day - 1] for this purpose are those specified townsite properties in respect of a mine that were previously eligible under subsection 1102(18) for depreciable property treatment.

Subsection 1102(14.3) prescribes property for the purpose of the rules relating to depreciable property in paragraph 13(7.5)(*b*) of the Act. The following properties are to be prescribed after [Budget Day - 1] for this purpose:

- a road (other than a temporary access road to an oil or gas well in Canada), sidewalk, airplane runway, parking area, storage area or similar surface construction,

- a bridge, and

- a property that is ancillary to any of the above properties.

Subsection 1102(18) is repealed as a consequence of the introduction of paragraph 13(7.5)(*a*) of the Act. The repeal of subsection 1102(18) applies in respect of payments required to be made under the terms of contracts made after [Budget Day - 1].

ITR
1104(6.1)

Subsections 1104(5) and (6) of the Regulations provide that, for specified purposes, the expression "income from a mine" includes income from listed activities. The definition is primarily relevant for the purpose of determining the capital cost allowance to which taxpayers engaged in mining activities are entitled. Taxpayers who operate mines are generally entitled to capital cost allowance of up to the amount of income from each eligible mine.

Subsection 1104(6.1) is introduced to clarify that, for these purposes, a taxpayer's mining income does not include income that can reasonably be attributed to a service rendered by the taxpayer (such as providing operational or administrative assistance to mining operators). The only exception to this rule applies for the purpose of Class 10. This exception allows those who process ore as a service

to others access to the higher capital cost allowance rates provided for depreciable property under Class 10.

This amendment applies to taxation years that begin after [Budget Day - 1].

ITR
1204(1)

Subsection 1204(1) of the Regulations defines the expression "resource profits", which is relevant for the purpose of determining the depletion deductions available to a taxpayer who has not fully utilized depletion pools generated as a consequence of pre-1990 activities. The resource profits of a taxpayer are also relevant for the purpose of determining the resource allowance that can be claimed by a taxpayer under section 1210 and for the purpose of computing the taxpayer's credit for manufacturing and processing under Part LII of the Regulations.

Existing subsection 1204(1) provides that the "resource profits" of a taxpayer for a taxation year are computed as follows:

- ADD, under paragraph 1204(1)(*a*), certain amounts relating to profits and recaptured deductions for the year on the disposition by the taxpayer of Canadian resource properties;

- ADD, under paragraph 1204(1)(*b*), the taxpayer's income from specified activities relating to the production and processing of petroleum, natural gas and related hydrocarbons and minerals;

- ADD, under paragraph 1204(1)(*b*.1), the taxpayer's specified rental or royalty income paid to the taxpayer relating to production from a property from which a person, other than a tax-exempt person, has a right to recover petroleum, natural gas, minerals or metals;

- ADD, under paragraph 1204(1)(*c*), where the taxpayer has a wholly-owned subsidiary that is a railway company, the railway company's income from the transportation of certain of the taxpayer's mineral ores; and

- SUBTRACT the taxpayer's losses from the specified activities referred to above.

Existing paragraphs 1204(1)(*d*) to (*f*) provide that only specified deductions are to be taken into account in computing a taxpayer's resource profits for a taxation year.

The existing rules are being substantially revised, in light of the decision of the Federal Court of Appeal in *The Queen v. Gulf Canada Limited*, 92 DTC 6123 and previously announced changes affecting the computation of resource allowance for members of partnerships.

Subsection 1204(1) is amended, effective for taxation years that begin after December 20, 1991, so that the amount calculated under that subsection is now referred to as "gross resource profits". This reflects the determination in the Gulf case that the existing wording in subsection 1204(1) is not sufficiently broad to take into account certain deductions related to the overall business that is associated with specified production and processing activities. A taxpayer's "resource profits" are now calculated under subsection 1204(1.1). "Adjusted resource profits", which are relevant for the purpose of the resource allowance, are calculated under amended subsection 1210(2). For further details, see the commentary on these provisions below.

One of the specified activities is described in existing subparagraph 1204(1)(*b*)(i) as the "production of petroleum, natural gas or related hydrocarbons from...petroleum or natural gas extracted by the taxpayer from a natural accumulation thereof in Canada". The existing wording is deficient, as petroleum, natural gas or related hydrocarbons are not "produced" from petroleum or natural gas itself. This subparagraph was meant to accommodate special oil recovery techniques, such as gravity-assisted drainage techniques. As a consequence, clause 1204(1)(*b*)(i)(*b*) is amended to describe the activity as the "production of petroleum, natural gas or related hydrocarbons from...natural accumulations (other than mineral resources) of petroleum or natural gas in Canada operated by the taxpayer". This is a relieving amendment and applies to taxation years that end after March 1985.

Paragraph 1204(1)(*b*.1) is amended, in conjunction with the repeal of subsection 1204(6), so that the exclusion relating to tax-exempt persons no longer applies. Note, however, that tax-exempt persons are subject to a penalty tax under Part XII of the Act with respect to certain interests in resource property in which taxable and tax-exempt persons each have an interest. This amendment is consequential to the expiration of transitional relief under Part XII of the Act, effective January 1, 1990. It applies to taxation years that begin after 1990.

Paragraph 1204(1)(*b*.1) is also amended to ensure that amounts included under paragraph 1204(1)(*b*) in computing a taxpayer's resource profits are not also included under paragraph 1204(1)(*b*.1). This amendment applies to taxation years that begin after 1990.

Paragraph 1204(1)(*f*) is amended to provide that deductions relating to mining reclamation trusts under new paragraphs 20(1)(ss) and (tt) of the Act do not result in a reduction of "gross resource profits". This amendment applies to taxation years that end after February 22, 1994, which is consistent with the coming-into-force for the provisions relating to such trusts.

ITR
1204(1.1) and (1.2)

New subsection 1204(1.1) of the Regulations, rather than subsection 1204(1), now sets out the rules governing the computation of a taxpayer's "resource profits".

A taxpayer's "resource profits" for a taxation year are determined by deducting from the taxpayer's "gross resource profits" the following amounts:

- Under paragraph 1204(1.1)(*b*), all amounts (other than deductions specified in any of subparagraphs 1204(1.1)(*b*)(i) to (v), described below) deducted in computing the taxpayer's income for the year;

- Under paragraph 1204(1.1)(*c*), specified amounts (described below) in connection with certain non-arm's length transactions; and

- Under paragraph 1204(1.1)(*d*), all amounts added under subsection 80(13) of the Act in computing the taxpayer's gross resource profits for the year.

As set out above, each deduction specified in any of subparagraphs 1204(1.1)(*b*)(i) to (v) is ignored for the purpose of computing a taxpayer's resource profits. As a consequence, a taxpayer's resource profits will not be reduced because of these specified deductions. The specified deductions are as follows:

- Subparagraph 1204(1.1)(*b*)(i) specifies any amount deducted in computing the taxpayer's gross resource profits. This subparagraph is intended to prevent double counting of those amounts that are deductible in computing gross resource profits.

- Subparagraph 1204(1.1)(*b*)(ii) specifies any amount deducted in computing income under section 8, paragraph 20(1)(ss) or (tt) (tt) or any of sections 60 to 64 or subsections 66(4), 66.7(2) and 104(6) and (12) of the Act or under section 1201 or any of subsections 1202(2), 1203(1), 1207(1) and 1212(1). The references to section 8 and sections 60 to 64 of the Act ensure that only deductions that relate to either business or property sources can result in a reduction of resource profits. The references to paragraphs 20(1)(ss) and (tt) of the Act, in conjunction with amended paragraph 1204(1)(*f*), reflect the policy that deductions for contributions to mining reclamation trusts should not reduce resource profits. The references to subsections 104(6) and (12) of the Act are consistent with the existing rule in subsection 1204(2).

- Subparagraph 1204(1.1)(*b*)(iii) specifies an amount deducted under section 66.2 of the Act in computing the income of the taxpayer for the year, to the extent that it is attributable to any right, licence or privilege to store underground in Canada petroleum, natural gas or related hydrocarbons. This is consistent with similar relief provided under existing paragraph 1204(1)(*e*).

- Subparagraph 1204(1.1)(*b*)(iv) specifies an amount deducted in computing the taxpayer's income for the year from a business, or other source, that does not include any "resource activity" of the

taxpayer (as defined in amended subsection 1206(1) and discussed in the commentary below).

- Subparagraph 1204(1.1)(*b*)(v) specifies an amount deducted in computing the taxpayer's income for the year, to the extent that the amount

  - relates to an activity that is not a "resource activity" of the taxpayer and that

    - is the production, processing, marketing, manufacturing, distribution, transportation or sale of any property,

    - is carried out for the purpose of earning income from property, or

    - is the rendering of a service by the taxpayer to another person for the purpose of earning income of the taxpayer, and

  - does not relate to a "resource activity" of the taxpayer.

The expression "resource activity" is defined in subsection 1206(1) and is described in the commentary below.

The premise underlying paragraph 1204(1.1)(*b*) is that all deductions claimed by a taxpayer are allocable on a reasonable basis to profit-earning activities of the taxpayer. With the limited exceptions provided under subparagraphs 1204(1.1)(*b*)(i) to (iv), it is intended that any amount deducted in computing a taxpayer's income also reduce the taxpayer's resource profits except to the extent that it can be allocated on a reasonable basis to a non-resource activity. For example, a corporation engaged in the production, processing and distribution of gas as part of one business would be required to allocate all of its deductions (other than deductions for which exceptions are provided under subparagraphs 1204(1.1)(*b*)(i) to (iii)) on a reasonable basis to the production function and the combined processing and distribution functions.

Under new paragraph 1204(1.1)(*c*), a taxpayer's resource profits are reduced to take into account the fair market value of property loaned, and services provided, after [Budget Day - 1] to the taxpayer by someone not dealing at arm's length with the taxpayer. New subsection 1204(1.2) provides a number a rules of application with respect to new paragraph 1204(1.1)(*c*).

More specifically, a taxpayer's resource profits for a taxation year are reduced under paragraph 1204(1.1)(*c*) by up to each amount that, on the basis of the assumption set out below, would have been charged to the taxpayer

- for the rental or other use after [Budget Day - 1] and in the year of a property (other than money) owned by a person or partnership with whom the taxpayer does not deal at arm's length, or

- for the provision after [Budget Day - 1] and in the year of a service by such a person or partnership to the taxpayer.

The above amount is calculated on the assumption that the person or partnership referred to had been dealing at arm's length with the taxpayer. The amount of the reduction is offset by the amount actually charged for the property or service. The amount of the reduction is also offset to the extent that the transaction does not relate to a resource activity.

New subsection 1204(1.2) provides a number of rules relevant for determining whether a person or a partnership (or two partnerships) do not deal with each other at arm's length for the purpose of paragraph 1204(1.1)(*c*). Subsection 1204(1.2) also provides that, for the purpose of that paragraph, a service rendered to a taxpayer does not include the provision of service by an individual in the individual's capacity as an employee of the taxpayer.

These amendments apply to taxation years that begin after December 20, 1991, although the amendments only have any impact with respect to taxation years ending after July 23, 1992. In addition, for a taxation year that straddles July 23, 1992, a special rule provides that the deduction under paragraph 1204(1.1)(*b*) in

computing resource profits is pro-rated in accordance with the number of days in the years before and after that date.

ITR
1204(3)

Subsection 1204(3) of the Regulations provides that the income or loss from a source described in paragraph 1204(1)(*b*) does not include any income or loss derived from transporting, transmitting or processing of petroleum, natural gas or related hydrocarbons. However, an exception is made with respect to the processing of tar sands and heavy crude oil.

Subsection 1204(3) is amended to clarify that resource profits also do not include any income or loss relating to mining reclamation trusts, pursuant to paragraphs 12(1)(z.1) or (z.2) or section 107.3 of the Act. This amendment applies to taxation years that end after February 22, 1994.

Subsection 1204(3) is also amended to make it clear that "resource profits" do not include any income or loss that is reasonably attributed to a service rendered by the taxpayer, other than the custom processing of ore. This amendment, which applies to taxation years that begin after [Budget Day - 1], is consistent with the rule described above in new subsection 1104(6.1), relating to the determination of mining income.

ITR
1204(6)

The repeal of subsection 1204(6) of the Regulations is discussed on the commentary to the amendments to subsection 1204(1). It applies to taxation years beginning after 1990.

ITR
1205(1)(*b*)

Subsection 1205(1) of the Regulations sets out the calculation of the "earned depletion base". Under paragraph 1205(1)(*b*), the earned depletion base of a taxpayer includes a specified percentage of the

taxpayer's qualifying pre-1990 expenditures on certain property (described in Class 10(k) of Schedule II to the Regulations) acquired for the purpose of gaining or producing income from a mine.

Paragraph 1205(1)(*b*) is amended so that Class 10(k) property of the type now included in Class 41 is treated in the same way as Class 10(k) property. This amendment, which applies to the 1988 and subsequent taxation years, is strictly consequential on earlier changes in the tax reform of 1987, involving changes to the capital cost allowance rates for depreciable property.

ITR
1205(1)(*d*.1)

Subsection 1205(1) of the Regulations sets out the calculation of the "earned depletion base". In the event that amounts subtracted in computing the earned depletion base at the end of a taxation year exceed the amounts added, the excess reduces the taxpayer's resource allowance for the year under subsection 1210(1). Under paragraph 1205(1)(*d*.1), the excess for a taxation year is added in computing the taxpayer's earned depletion base after the end of the year.

Paragraph 1205(1)(*d*.1) is amended, strictly as a consequence of the restructuring of section 1210, so that it refers to variables in the formula in subsection 1210(1) rather than provisions in section 1210. This amendment applies to taxation years that begin after December 20, 1991.

ITR
1206(1)

Subsection 1206(1) of the Regulations sets out definitions that are relevant for the purposes of Part XII of the Regulations.

ITR
1206(1)

"exempt partnership"

Subsection 1206(1) of the Regulations is amended to introduce the definition "exempt partnership", which is used in new subsection 1210(4). For details, see the commentary on that subsection.

ITR
1206(1)

"processing property"

Under paragraph 1205(1)(*a*) of the Regulations, the "earned depletion base" of a taxpayer includes a specified percentage of the taxpayer's pre-1990 expenditures on specified "processing property". "Processing property" is defined as certain property that is described in Class 10(g) or (k) or that would be described if certain assumptions were made.

The definition "processing property" is amended so that it continues to include property now included in Class 41, to the extent that such property would have been covered by the definition prior to the introduction of Class 41.

This amendment, which applies to the 1988 and subsequent taxation years, is strictly consequential on earlier changes in the tax reform of 1987, involving changes to the capital cost allowance rates for depreciable property.

ITR
1206(1)

"production royalty"

A "production royalty" is, in general terms, a rental or royalty received by a taxpayer in respect of oil or gas, where the taxpayer bears the Crown royalty in respect of either the production of the oil

or gas or the ownership of property to which such production relates. Subparagraph (*a*)(ii) of the definition is amended to add words that were inadvertently omitted when the definition was last amended.

This amendment applies in respect of rentals and royalties computed by reference to the amount or value of petroleum, natural gas or related hydrocarbons produced after June 30, 1988.

ITR
1206(1)

"resource activity"

This expression is used in new subsection 1204(1.1) of the Regulations and amended subsection 1210(2) of the Regulations. For further details, see the commentary on those subsections.

A taxpayer's "resource activity" is defined in paragraphs (*a*) to (*e*) of the definition to include the same specified production and processing activities set out in subsection 1204(1), except that references to properties being operated by a taxpayer have been eliminated and there are a number of supplementary rules set out in paragraphs (*f*) to (j) of the definition which apply for the purpose of determining whether an activity is characterized as a "resource activity".

Under paragraph (*f*) of the definition, the "production" of a substance by a taxpayer includes exploration and development activities of the taxpayer with respect to the substance. This rule applies whether or not the extraction of the resource has begun or will ever begin.

Under paragraph (g) of the definition, the production, the processing or the production and processing of a substance by a taxpayer is considered to include activities performed by the taxpayer that are ancillary to, or in support of, the production, the processing or the production of that substance by the taxpayer. For example, scientific research expenditures may be required to be deducted in computing resource profits as a consequence of this rule. See, however, the commentary below on paragraph (j) of the definition.

Under paragraph (h) of the definition, the production or processing of a substance by a taxpayer includes an activity (including the ownership of property) that is undertaken before the extraction of the substance and that is undertaken for the purpose of extracting or processing the substance. This ensures that capital cost allowance claimed for a taxation year with respect to a production facility not yet in production will be required to be deducted in computing resource profits.

Under paragraph (i) of the definition, the production, the production and processing or the processing of a substance by a taxpayer includes activities that the taxpayer is obliged to perform as a direct consequence of the production, production and processing or processing. For example, costs of environmental clean-up that are deducted in computing income will also be required to be deducted in computing resource profits.

Under paragraph (j) of the definition, a resource activity expressly excludes specified activities. The activities specified are the transporting, transmitting or processing of petroleum, natural gas or related hydrocarbons (other than tar sands or heavy crude oil). In addition, a specified activity includes one which can reasonably be attributed to a service rendered. However, a taxpayer's activities are only specified for this purpose where there are revenues derived from the activities and those revenues are not taken into account in computing the taxpayer's gross resource profits. Paragraph (j) of the definition is parallel to subsection 1204(3).

This definition applies to taxation years that begin after December 20, 1991. However, as explained in the commentary to new subsection 1204(1.1) and section 1210, it only has impact for taxation years that end after July 23, 1992.

ITR
1206(1)

"specified net royalty"

Subsection 1206(1) of the Regulations introduces the definition "specified net royalty", which is used in the computation of adjusted

resource profits under subsection 1210(2). In general terms, specified net royalties are those royalties paid in respect of interests generally referred to as "net profit interests".

More specifically, a "specified net royalty" is defined as a royalty (other than a production royalty defined in subsection 1206(1)) created after [Budget Day - 1] (otherwise than pursuant to an agreement in writing made before Budget Day) where any amount paid or payable to the holder of the royalty because of the holder's interest in the royalty is calculated with reference to any expense. In addition, where an arrangement involving the reimbursement of, contribution to or allowance for, any expense has been made after [Budget Day - 1], that arrangement will result in the royalty being a specified net royalty if one of the reasons for the arrangement was to escape classification as a "specified net royalty".

Under amended subsection 1210(1), payments made in respect of specified net royalties are now required reduce the payer's adjusted resource profits. One-half of those payments are added, under that subsection, in computing the recipient's resource profits.

The reason for these proposed amendments is that the existing resource allowance rules have given rise to a number of financing arrangements under which net profit interests are used to significantly increase the overall resource allowance that is available. By carving out a net profit interest from a working interest, the holder of the working interest can substantially decrease the amount paid for depreciable properties associated with the working interest. As a consequence, the amount of the resource profits that qualify for the resource allowance can be inappropriately increased.

These amendments apply after [Budget Day - 1].

ITR
1206(9)

Section 1210 of the Regulations is designed so that recipients of "production royalties" are entitled to resource allowance with respect to those royalties, whereas payments of "production royalties" result in the reduction of resource allowance for the payer. To qualify as a

"production royalty" under subsection 1206(1), the recipient of the royalty must bear the cost of a "Crown royalty". Subsection 1206(9) generally provides that a taxpayer is considered to bear the cost of a Crown royalty for this purpose where paragraph 12(1)(o) or 18(1)(m) of the Act has applied to the taxpayer with respect to the payment by the taxpayer of a Crown royalty. However, in the event that a Crown royalty is reimbursed to a taxpayer, the taxpayer is not considered to have borne the Crown royalty. (Instead, because of section 80.2 of the Act, the reimbursing party is considered to bear the cost of the Crown royalty.)

Subsection 1206(9) is amended so that the rules for reimbursements of Crown royalties also apply to contributions or allowance in respect of Crown royalties. This amendment is consequential to a similar change to section 80.2 of the Act.

This amendment applies after January 1990.

ITR
1210(1)

Subsection 1210(1) of the Regulations provides the detailed calculation for the "resource allowance" pursuant to paragraph 20(1)(v.1) of the Act. Under the existing rules, a taxpayer's "resource allowance" for a taxation year is the amount calculated under that subsection, which is generally equal to 25% of an amount determined with reference to "resource profits", as determined under subsection 1204(1).

Subsection 1210(1) has been amended so the calculation of the resource allowance is based on a formula. In addition, most of the details of the calculation of the resource allowance are now provided under amended subsections 1210(2) and (3) rather than in subsection 1210(1). A taxpayer's resource allowance for a taxation year is determined as follows under section 1210:

- COMPUTE the amount, if any, by which the taxpayer's adjusted resource profits (as determined under amended subsection 1210(2)) exceeds Canadian exploration and development overhead expenses described in the description of B in section 1210;

- MULTIPLY the amount computed above by 25%, and

- SUBTRACT from that product the "negative" earned depletion base.

These amendments apply to taxation years that begin after December 20, 1991.

ITR
1210(2)

Subsection 1210(2) of the Regulations provides that a partner cannot claim a resource allowance with respect to partnership level income.

Subsection 1210(2) is amended so that it now provides a definition of "adjusted resource profits", which is used in subsection 1210(1). As described below, partnerships are provided for elsewhere in the rules.

New subsection 1210(2) is, in part, derived from the existing rules in subsection 1210(1). The new subsection also addresses issues related to *The Queen v. Gulf Canada Limited* (92 DTC 6123) and, in conjunction with new subsections 1210(3) and (4), the treatment of members of partnerships.

Under new subsection 1210(2), the adjusted resource profits of a taxpayer is the positive or negative amount determined by the formula:

A + B - C

The amount determined for A in respect of a taxpayer for a taxation year is the taxpayer's resource profits (as determined under subsection 1204(1.1)) for the year, calculated in accordance with the following assumptions:

- The first assumption, which is contained in paragraph 1210(2)A(*a*) and is consistent with existing subparagraph 1210(1)(*a*)(i), is that no amount is added under paragraph 1204(1)(*a*) in computing gross resource profits.

- The second assumption, which is contained in paragraph 1210(2)A(*b*) and is consistent with existing subparagraph 1210(1)(*a*)(i), is that the processing of foreign ore is ignored.

- The third assumption, which is contained in subparagraph 1210(2)A(*c*)(i), is that deductions in respect of certain rental and royalty payments made are ignored. This assumption is identical in effect to the existing rules in subsection 1210(1) for such payments. The only change relates to any royalty that is a "specified net royalty", as newly defined in amended subsection 1206(1). For an explanation of this change, see the commentary above on the new definition.

- The fourth assumption, which is contained in subparagraph 1210(2)A(*c*)(ii), is that deductions in computing the taxpayer's income for the year under any of paragraphs 20(1)(*e*), (*e*.1), (*e*.2) or (*f*) of the Act or as, on account of or in lieu of, interest in respect of a debt owed by the taxpayer are ignored. This assumption applies only to taxation years that begin after March 18, 1993, which is the date on which restrictions in this respect were announced. The measure is somewhat narrower than the rule in existing clause 1210(1)(*a*)(i)(C), under which all deductions "in respect of financing" are ignored.

- The fifth assumption, which is contained in subparagraph 1210(2)A(*c*)(iii), is that deductions under any of paragraph 20(1)(v.1) (resource allowance) or sections 65 to 66.7 of the Act (resource deductions) or subsections 17(2) or (6) or section 29 of the *Income Tax Application Rules* (resource deductions) are ignored. This assumption is consistent with existing clause 1210(1)(*a*)(i)(C).

- The sixth assumption, which is contained in paragraph 1210(2)A(*d*), is that the taxpayer's share of any income or loss of a partnership are ignored. (Note, however, that a member's share of a partnership's income or loss is taken into account under the description of B.)

- The last assumption is that "gross resource profits" under subsection 1204(1) and "resource profits" under subsection 1204(1.1) are structured so that negative amounts could be determined under those provisions. This assumption is relevant only where a taxpayer is a member of a partnership and, as a consequence, the "adjusted resource profits" of the taxpayer are increased because of the description of B. Because of this assumption, the amount determined for A in subsection 1210(2) can be negative and, as a consequence, offset the amount determined for B in subsection 1210(2).

The amount determined for B in respect of a taxpayer for a taxation year is the total of the taxpayer's shares of adjusted resource profits of partnerships for the year, as determined under subsection 1210(3). The description of B is consequential on changes made to subsection 96(1) of the Act as part of Bill C-92, under which the resource allowance is computed at the partner level rather than the partnership level. These changes were originally announced on December 20, 1991 and described in further detail by way of a press release issued by the Minister of Finance on March 18, 1993. For further details, see the commentary on subsection 1210(3).

Subject to the new change for specified net royalties, the amount determined for C in respect of a taxpayer for a taxation year is equal to the total of rental or royalty receipts of the taxpayer that are included in the taxpayer's gross resource profits and that are currently described in subparagraph 1210(1)(*a*)(iii). However, for taxation years that end after [Budget Day - 1], the amount determined for C is offset by all the outlays and expenses that were incurred in respect of such total and that were deducted in computing the taxpayer's gross resource profits for the year.

The amount determined for C now also includes 1/2 of any amount included in computing a taxpayer's gross resource profits for the year in respect of any "specified net royalty", as newly defined in subsection 1206(1). For further details, see the commentary above on the new definition.

These amendments apply to taxation years that begin after December 20, 1991, although the new rules for specified net royalties apply only after [Budget Day - 1].

ITR
1210(3) and (4)

New subsection 1210(3) of the Regulations provides a formula for determining a taxpayer's share for a taxation year of a partnership's adjusted resource profits. The formula applies in respect of partnership fiscal periods that began after December 20, 1991; in all other cases the taxpayer's share of such profits is considered to be nil as the resource allowance was claimed at the partnership level for previous fiscal periods.

A taxpayer's share of adjusted resource profits is added in computing the taxpayer's adjusted resource profits under the description of B in subsection 1210(1). Except where the share is considered to be nil or where the transitional rule described below applies, the share of a partner for a taxation year is the negative or positive amount that would represent the partner's share of the adjusted resource profits of the partnership for the taxation year if the partnership were a taxpayer and its fiscal period were a taxation year.

A special rule applies where a taxpayer is a member of an "exempt partnership", as defined in amended subsection 1206(1), at the end of a partnership's fiscal period that began before 2000. If this is the case, any negative share of the taxpayer otherwise determined under subsection 1210(3) in respect of the partnership for the fiscal period is multiplied by a specified factor under new subsection 1210(4), as described below.

An "exempt partnership" in respect of a taxpayer at a particular time means a partnership of which the taxpayer has been a member since December 20, 1991 where all or substantially all of the fair market value of the property of the partnership at the particular time is attributable to property held in connection with one or more working interests that were held by the partnership on December 20, 1991 for the current or future production of minerals, petroleum, natural gas or related hydrocarbons.

Notwithstanding the above, if any depreciable property acquired after December 20, 1991 by the partnership in connection with the working interest was owned prior to the acquisition by the taxpayer (or any person with whom the taxpayer did not deal at arm's length) and was used by the taxpayer (or that other person) in connection with the working interest, the partnership will cease to qualify as an "exempt partnership" in respect of the taxpayer. In addition, an exempt partnership will cease to qualify as such where it is reasonable to consider that costs or fees were charged to the partnership that would not have been so charged if it were not for the favourable treatment of "exempt partnerships".

The specified factor for a member of an exempt partnership for a fiscal period is nil where, at the end of the fiscal period, all or substantially all of the assets of the partnership were held in connection with one or more working interests

- the production from which began in reasonable commercial quantities before December 21, 1991, or

- the production from which was to begin in reasonable commercial quantities after December 20, 1991 in accordance with an agreement in writing entered into before December 21, 1991.

In other circumstances where there is an exempt partnership, the specified factor for a fiscal period is equal to the lesser of

- one, and

- one minus the fraction obtained when the partnership's adjusted resource profits (determined with reference only to working interests described immediately above) is divided by the partnership's adjusted resource profits for the period.

The first example below illustrates the operation of the rules for exempt partnerships. The second example provides a more detailed fact situation, which illustrates more generally the mechanics of the new rules for calculating gross resource profits, resource profits, adjusted resource profits and the resource allowance.

EXAMPLE 1

Facts

Corporation A is a member of an "exempt partnership" during a fiscal period of the partnership. However, less than 90% of its assets are held in connection with working interests referred to in subparagraph 1210(4)B(*a*)(ii). Corporation A's share of the adjusted resource profits of the partnership for the fiscal period, otherwise determined, is $ -1,000. The total of the adjusted resource profits of the partnership for the fiscal period is $ -2,000. The total of the partnership's adjusted resource profits for the fiscal period, determined without reference to working interests relevant for determining status as an exempt partnership, is $ -1,600.

Results

1. Paragraph 1210(4)B(*a*) does not apply to reduce the specified factor to nil because an insufficient percentage of Corporation A's assets are held in connection with qualifying working interests.

2. The specified factor, as determined under paragraph 1210(4)B(*b*), is equal to .8 (which is (-1,600)/(-2,000)).

3. As a consequence, Corporation A's share of the partnership's adjusted resource profits for the fiscal year is considered to be $ -800 (.8 x $ -1,000).

EXAMPLE 2

Facts

In this example, the following acronyms are used:

- G & A (General & Administrative expenses),
- CCA (Capital cost allowance, as claimed under the Act),
- SR & ED (Scientific research and experimental development expense),
- CEE (Canadian exploration expense),
- CDE (Canadian development expense),
- FEDE (foreign exploration and development expenses), and
- CEDOE (Canadian exploration and development overhead expense, as defined in subsection 1206(1)).

It is assumed that Oilco, which carries on a single business, has the following revenues, expenses and deductions that were taken into account in computing Oilco's income for the 1995 taxation year. The royalties referred in the example are assumed to be neither "specified net royalties" nor "production royalties" (as those expressions are defined in subsection 1206(1)).

EXAMPLE 2 (continued)

Revenues/Expenses and Income from Activities

1.	Revenues from use of pipeline	$ 20,000		
2.	Pipeline operating expense		10,000	
3.	Direct G & A attributable to pipeline		1,000	
4.	Interest expense attributable to pipeline		1,000	
5.	CCA attributable to pipeline		4,000	
6.	SR & ED attributable to pipeline		1,000	
7.	NET PIPELINE INCOME			3,000
8.	Oil and gas production revenues, including crown charges	60,000		
9.	Production operating expenses		15,000	
10.	Direct G & A attributable to production		5,000	
11.	Interest expense attributable to production		1,000	
12.	CCA (including pre-production CCA)		7,500	
13.	SR & ED (including SR & ED in respect of future production)		4,000	
14.	Royalties paid		500	
15.	NET PRODUCTION INCOME			27,000
16.	SHARE OF RESOURCE PARTNERSHIP INCOME			1,000
17.	Resource royalty revenues	3,000		
18.	Direct G & A attributable to royalties		600	
19.	NET RESOURCE ROYALTY INCOME			2,400
20.	**TOTAL NET INCOME, BEFORE ADJUSTMENTS**			**33,400**
	OTHER RELEVANT INFORMATION			
21.	Gas plant profits, as per GC2 forms			3,000
22.	G & A that is not allocable to pipeline or royalty activities			4,000
23.	CEE			3,000
24.	CDE			1,000
25.	FEDE			1,000
26.	Resource allowance (as per calculation below)		5,125	
27.	CEDOE			2,000

EXAMPLE 2 (continued)

Results

(i) Calculation of "Gross Resource Profits" under Subsection 1204(1)

Paragraph 1204(1)(*a*)	$ NIL
Paragraph 1204(1)(*b*)	
Net production income (line 15)	27,000
ADD SR & ED (line 13, as per Gulf case)	4,000
MINUS gas plant profits (line 21)	(3,000)
MINUS CEE and CDE claims (lines 23 and 24)	(4,000)
Paragraph 1204(1)(*b*.1)	
Net resource royalty income (line 19)	2,400
Subsection 1206(3)	
Share of resource partnership income (line 16)	1,000
Gross resource profits, before line 26	27,400

(ii) Calculation of "Resource Profits" under Subsection 1204(1.1)

Paragraph 1204(1.1)(*a*)	
Gross resource profits, before line 26	27,400
Paragraph 1204(1.1)(*b*)	
MINUS SR & ED (line 13)	4,000
MINUS Unallocated G & A (line 22)	4,000
Resource Profits, before line 26	19,400

As shown below, the resource allowance deduction is $5,125, which means that the resource profits of the taxpayer for the year is equal to $14,275.

EXAMPLE 2 (continued)

(iii) Calculation of Adjusted Resource Profits under Subsection 1210(2)

1210(2)A

Resource profits, before line 26	19,400
ADD resource royalty paid (line 14)	500[1]
ADD interest expense (line 11)	1,000[2]
ADD CEE/CDE (lines 23 and 24)	4,000[3]
SUBTRACT share of resource partnership income (line 16)	(1,000)[4]
1210(2)B	
Share of partnership adjusted resource profits (line 16)	1,000
1210(2)C	
Net resource royalties received (line 19)	(2,400)
Adjusted resource profits	22,500

Notes:

1. See third assumption with respect to s.1210(2)A, described above.
2. See fourth assumption with respect to s. 1210(2)A, described above.
3. See fifth assumption with respect to s. 1210(2)A, described above.
4. See sixth assumption with respect to s. 1210(2)A, described above.

(iv) Calculation of Resource Allowance

1210(1)

25% of (Adjusted Resource profits - CEDOE (line 27)
= .25 X ($22,500 - 2,000)
= $5,125

ITR
5202 and 5203

A corporation's manufacturing and processing tax credit is based, in part, on the corporation's "adjusted business income". A corporation's adjusted business income is reduced to reflects its "Canadian resource profits" and "resource profits".

Cross references in the definitions "Canadian resource profits" and "resource profits" in section 5202 have been changed to reflect the proposed amendments to Part XII of the Regulations. These amendments apply to the 1990 and subsequent taxation years.

The definition "adjusted business income" in section 5203, which applies only for taxpayers that engage in resource activities, is amended to clarify that corporations are not entitled to claim the manufacturing and processing tax credit with respect to refund interest. This amendment applies to refund interest received or receivable after [Budget Day - 1].

New subsection 5203(4) provides that a taxpayer's "refund interest" is any amount received by the taxpayer because of the overpayment of non-deductible Canadian taxes, Crown royalties or other Crown charges. The Crown royalties and charges to which this definition applies are those to which paragraphs 12(1)(o) and 18(1)(m) apply.

The amendments to section 5203 ensure that corporations in the mining and oil and gas sectors will not be entitled to increase their entitlement to the manufacturing and processing tax credit because of the receipt of refund interest. These amendments are not to be construed as implying that the receipt of refund interest previously had the result of increasing such entitlement. It is intended that these amendments not affect Revenue Canada's administrative practices.

It is important to note that these amendments affecting resource corporations do not alter the treatment of refund interest. Refund interest is generally regarded as investment income and these amendments merely confirm the calculation of the manufacturing and processing tax credit for the mining and oil and gas sectors that are presently receiving large amounts of refund interest.

ITR
Schedule II
Class 8

Class 8 of Schedule II to the Regulations describes property that is eligible for a 20% write-off rate. Paragraph (i) of that class includes

tangible property that is not included in any other class, other than a number of listed exclusions.

Paragraph (i) of Class 8 is amended to ensure that roads are not included in Class 8. Temporary access roads built by a taxpayer to an oil and gas well in Canada are classified as Canadian exploration expenses or Canadian development expenses. Other roads are included in Class 17, except for forestry and mining roads that are included in other classes. For further discussion on the rules for roads, see the commentary on new subsection 13(7.5) of the Act.

This amendment applies to property acquired after [Budget Day - 1].

ITR
Schedule II
Class 17

Class 17 of Schedule II to the Regulations describes property that is eligible for an 8% write-off rate. Roads not classified elsewhere (i.e., mining or forestry roads in Classes 15 or 41) are included in Class 17.

Class 17 is amended so that it does not extend to temporary access roads built by a taxpayer to oil and gas wells in Canada. Expenditures of this nature qualify as Canadian exploration expense or Canadian development expense under subsections 66.1(6) and 66.2(5) of the Act. For further discussion on the rules for roads, see the commentary on new subsection 13(7.5) of the Act.

This amendment applies to property acquired after [Budget Day - 1].